HARRIS PREFERRED CAPITAL CORP
Form 10-Q
August 15, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005

COMMISSION FILE NUMBER 1-13805

HARRIS PREFERRED CAPITAL CORPORATION
(Exact name of registrant as specified in its charter)

MARYLAND (State or other jurisdiction of incorporation or organization)	# 36-4183096 (I.R.S. Employer Identification No.)
111 WEST MONROE STREET, CHICAGO, ILLINOIS (Address of principal executive offices)	60603 (Zip Code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE:
(312) 461-2121

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A, par value $1.00 per share	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X]   No [ ]

Indicate by check mark whether this registrant is an accelerated filer (as defined in Rule 12b-2 of the Act)

Yes [ ]   No [X]

The number of shares of Common Stock, $1.00 par value, outstanding on August 12, 2005 was 1,000. No common equity is held by nonaffiliates.

HARRIS PREFERRED CAPITAL CORPORATION

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

	JUNE 30, 2005	DECEMBER 31, 2004	JUNE 30 2004
	(UNAUDITED)	(AUDITED)	(UNAUDIT
	(IN THOUSANDS, EXCEPT SHARE DATA)		
ASSETS			

Cash on deposit with Harris N.A.	$ 438	$ 407	$ 6,08
Securities purchased from Harris N.A. under agreement to resell..	13,000	10,500	16,00
Notes receivable from Harris N.A.	10,504	12,129	14,01
Securities available-for-sale:			
Mortgage-backed.....................................	431,355	419,315	405,24
U.S. Treasury.......................................	29,988	44,993	39,80
Securing mortgage collections due from Harris N.A.	--	78	28
Other assets..	1,657	1,600	1,64
TOTAL ASSETS.....................................	$486,942	$489,022	$483,06
LIABILITIES AND STOCKHOLDERS' EQUITY			
Accrued expenses..	$ 93	$ 134	$ 3
Commitments and contingencies............................	--	--	-
STOCKHOLDERS' EQUITY			
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A ($1 par value); liquidation value of $250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding.......................................	250,000	250,000	250,00
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding................................	1	1	
Additional paid-in capital................................	240,733	240,733	240,73
Distributions in excess of earnings......................	(379)	(582)	(63
Accumulated other comprehensive loss -- net unrealized losses on available-for-sale securities................	(3,506)	(1,264)	(7,06
TOTAL STOCKHOLDERS' EQUITY........................	486,849	488,888	483,03
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.........	$486,942	$489,022	$483,06

The accompanying notes are an integral part of these consolidated financial statements.

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME
AND COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30		SIX MONTHS ENDED JUNE 30	
	2005	2004	2005	2004
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
INTEREST INCOME:				
Securities purchased from Harris N.A. under agreement to resell..........................	$ 251	$ 312	$ 451	$ 783
Notes receivable from Harris N.A.	171	234	355	492
Securities available-for-sale:				

Mortgage-backed	4,601	3,299	9,167	5,929
U.S. Treasury	17	2	36	26
Total interest income	5,040	3,847	10,009	7,230
NON-INTEREST INCOME:				
(Loss) gain on sale of securities	(178)	--	(372)	398
OPERATING EXPENSES:				
Loan servicing fees paid to Harris N.A.	8	12	16	24
Advisory fees paid to Harris N.A.	41	28	65	57
General and administrative	33	97	135	193
Total operating expenses	82	137	216	274
Net income	4,780	3,710	9,421	7,354
Preferred dividends	4,609	4,609	9,218	9,218
NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDER	$ 171	$ (899)	$ 203	$ (1,864)
Basic and diluted earnings (loss) per common share	$171.00	$(899.00)	$203.00	$(1,864.00)
Net income	$ 4,780	$ 3,710	$ 9,421	$ 7,354
Other comprehensive income (loss) -- net unrealized gains/(losses) on available-for-sale securities	4,200	(10,143)	(2,242)	(9,337)
Comprehensive income (loss)	$ 8,980	$ (6,433)	$ 7,179	$ (1,983)

The accompanying notes are an integral part of these consolidated financial statements.

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2005	2004
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Balance at January 1	$488,888	$494,234
Net income	9,421	7,354
Other comprehensive loss	(2,242)	(9,337)
Dividends (preferred stock $0.4609 per share)	(9,218)	(9,218)
Balance at June 30	$486,849	$483,033

The accompanying notes are an integral part of these consolidated financial statements.

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30 2005	SIX MONTHS ENDED JUNE 30 2004
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 9,421	$ 7,354
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss (gain) on sale of securities	372	(398)
Net increase in other assets	(57)	(564)
Net decrease in accrued expenses	(41)	(51)
Net cash provided by operating activities	9,695	6,341
INVESTING ACTIVITIES:		
Net increase in securities purchased from Harris N.A. under agreement to resell	(2,500)	(4,500)
Repayments of notes receivable from Harris N.A.	1,625	2,534
Decrease in securing mortgage collections due from Harris N.A.	78	133
Purchases of securities available-for-sale	(113,565)	(516,889)
Proceeds from sales of securities available-for-sale	--	10,989
Proceeds from maturities of securities available-for-sale	113,916	515,765
Net cash (used) provided by investing activities	(446)	8,032
FINANCING ACTIVITIES:		
Cash dividends paid on preferred stock	(9,218)	(9,218)
Net increase in cash on deposit with Harris N.A.	31	5,155
Cash on deposit with Harris N.A. at beginning of period	407	926
Cash on deposit with Harris N.A. at end of period	$ 438	$ 6,081

The accompanying notes are an integral part of these consolidated financial statements.

HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Harris Preferred Capital Corporation (the "Company") is a Maryland corporation whose principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust ("REIT") assets (the "Mortgage Assets"), consisting of a limited recourse note or notes (the "Notes") issued by Harris N.A. (the "Bank") secured by real estate mortgage assets (the "Securing Mortgage Loans") and other obligations secured by real property, as well as certain other qualifying REIT assets, primarily U.S. treasury securities and securities collateralized with real estate mortgages. The Company holds its assets through a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. Harris Capital Holdings, Inc., owns 100% of the Company's common stock. The Bank owns all common stock outstanding issued by Harris Capital Holdings, Inc.

The accompanying consolidated financial statements have been prepared by management from the books and records of the Company. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented and should be read in conjunction with the notes to financial statements included in the Company's 2004 Form 10-K. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

2. COMMITMENTS AND CONTINGENCIES

Legal proceedings in which the Company is a defendant may arise in the normal course of business. There is no pending litigation against the Company.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING INFORMATION

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectation, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company's statements regarding tax treatment as a real estate investment trust, liquidity, provision for loan losses, capital resources and investment activities. In addition, in those and other portions of this document, the words "anticipate," "believe," "estimate," "expect," "intend" and other similar expressions, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. It is important to note that the Company's actual results could differ materially from those described herein as anticipated, believed, estimated or expected. Among the factors that could cause the results to differ materially are the risks discussed in the "Risk Factors" section included in the Company's Registration Statement on Form S-11 (File No. 333-40257), with respect to the Preferred Shares declared effective by the Securities and Exchange Commission on February 5, 1998. The Company assumes no obligation to update any such forward-looking statement.

RESULTS OF OPERATIONS

SECOND QUARTER 2005 COMPARED WITH SECOND QUARTER 2004

The Company's net income for the second quarter of 2005 was $4.8 million. This represented a $1.1 million or 29% increase from second quarter 2004 earnings of $3.7 million. Earnings increased primarily because of increased interest income on earning assets.

Interest income on securities purchased under agreement to resell for the second quarter 2005 was $251 thousand, a decrease of $61 thousand from the same period in 2004, because the average outstandings declined by $63 million, partially offset by an increase in market rates over the same period. Second quarter 2005 interest income on the Notes totaled $171 thousand and yielded 6.4% on $10.7 million of average principal outstanding for the quarter compared to $234 thousand and a 6.4% yield on $14.7 million average principal outstanding for second quarter 2004. The decrease in income was attributable to a reduction in the Note balance because of principal paydowns by customers in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans for second quarter 2005 and 2004 was $13 million and $18 million, respectively. Interest income on securities available-for-sale, including mortgage-backed and U.S. Treasury securities, for the current quarter was $4.6 million resulting in a yield of 4.3% on an average balance of $433 million, compared to $3.3 million with a yield of 4.3% on an average balance of $310 million for the same period a year ago. The increase in interest income is primarily attributable to the increase in the investment portfolio of mortgage-backed securities.

There were no Company borrowings during second quarter 2005 or 2004.

Second quarter 2005 operating expenses totaled $82 thousand, a decrease of $55 thousand or 40% from the second quarter of 2004. Loan servicing expenses totaled $8 thousand, a decrease of $4 thousand from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the second quarter 2005 were $41 thousand compared to $28 thousand a year earlier. The increase is partially due to increased internal processing costs. General and administrative expenses totaled $33 thousand, a decrease of $64 thousand over the same period in 2004 as a result of lower legal, processing, recordkeeping and administration costs.

At June 30, 2005 and 2004, there were no Securing Mortgage Loans on nonaccrual status.

SIX MONTHS ENDED JUNE 30, 2005 COMPARED WITH JUNE 30, 2004

The Company's net income for the six months ended June 30, 2005 was $9.4 million. This represented a $2.1 million increase or 28% from 2004 earnings. Earnings increased primarily because of the increase in the investment portfolio of mortgage-backed securities which improved the overall yield on earning assets.

Interest income on securities purchased under agreement to resell for the six months ended June 30, 2005 was $451 thousand, a decrease of $332 thousand from the same period in 2004, because the average outstandings declined by $100 million partially offset by an increase in the market rate over the same period. Interest income on the Notes for the six months ended June 30, 2005 totaled $355 thousand and yielded 6.4% on $11 million of average principal outstanding compared to $492 thousand of income yielding 6.4% on $15 million of average principal outstanding for the same period in 2004. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was $14 million for the six months ended June 30, 2005 and $19 million for the same period in 2004. There were no Company borrowings during either period. Interest income on securities available-for-sale for the six months ended June 30, 2005 was $9.2 million resulting in a yield of 4.2% on an average balance of $435 million, compared to $6.0 million resulting in a yield of 4.3% on an average balance of $277 million a year ago. The increase in interest income from available-for-sale securities is primarily attributable to the increase in the portfolio of mortgage-backed securities.

Operating expenses for the six months ended June 30, 2005 totaled $216 thousand, a decrease of $58 thousand from a year ago. Loan servicing expenses for the six months ended June 30, 2005 totaled $16 thousand, a decrease of $8 thousand or 33% from 2004. This decrease is attributable to the reduction in the principal balance of the Notes because servicing costs vary directly with these balances. Advisory fees for the six months ended June 30, 2005 were $65 thousand compared to $57 thousand a year ago; primarily attributable to increased internal costs for processing, recordkeeping and administration. General and administrative expenses totaled $135 thousand, a decrease of $58 thousand or 30% over the same period in 2004 as a result of reduced costs for insurance, compliance, printing and processing costs.

On June 30, 2005, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on June 15, 2005, as declared on June 2, 2005. On June 30, 2004, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on June 15, 2004, as declared on June 1, 2004. On a year-to-date basis, the Company declared and paid $9.2 million of dividends to holders of preferred shares for each of the six-month periods ended June 30, 2005 and 2004.

At June 30, 2005, net unrealized losses on available-for-sale securities were $3.5 million compared to $7.1 million of unrealized losses at June 30, 2004 and $1.3 million of unrealized losses at December 31, 2004. The unrealized loss positions at June 30, 2005 and 2004 and December 31, 2004 were attributed to changes in interest rates and not to lowered credit quality of individual securities and therefore management believes these losses are temporary.

LIQUIDITY RISK MANAGEMENT

The objective of liquidity management is to ensure the availability of sufficient cash flows to meet all of the Company's financial commitments. In managing liquidity, the Company takes into account various legal limitations placed on a REIT.

The Company's principal asset management requirements are to maintain the current earning asset portfolio size through the acquisition of additional Notes or other qualifying assets in order to pay dividends to its stockholders after satisfying obligations to creditors. The acquisition of additional Notes or other qualifying assets is funded with the proceeds obtained as a result of repayment of principal balances of individual Securing Mortgage Loans or maturities or sales of securities. The payment of dividends on the preferred shares is made from legally available funds, arising from operating activities of the Company. The Company's cash flows from operating activities principally consist of the collection of interest on the Notes, mortgage-backed securities and other earning assets. The Company does not have and does not anticipate having any material capital expenditures.

In order to remain qualified as a REIT, the Company must distribute annually at least 90% of its adjusted REIT ordinary taxable income, as provided for under the Internal Revenue Code, to its common and preferred stockholders. The Company currently expects to distribute dividends annually equal to 90% or more of its adjusted REIT ordinary taxable income.

The Company anticipates that cash and cash equivalents on hand and the cash flow from the Notes and mortgage-backed securities will provide adequate liquidity for its operating, investing and financing needs including the capacity to continue preferred dividend payments on an uninterrupted basis.

As presented in the accompanying Consolidated Statements of Cash Flows, the primary sources of funds in addition to $9.7 million provided from operations during the six months ended June 30, 2005 were $1.6 million provided by principal repayments on the Notes and $113.9 million from the maturities of securities available-for-sale. In the prior period ended June 30, 2004, the primary sources of funds other than $6.3 million from operations were $2.5 million provided by principal repayments on the Notes and $526.8 million from the maturities and sales of securities available-for-sale. The primary uses of funds for the six months ended June 30, 2005 were $113.6 million for purchases of securities available-for-sale and $9.2 million in preferred stock dividends paid. For the prior year's quarter ended June 30, 2004, the primary uses of funds were $516.9 million for purchases of securities available-for-sale and $9.2 million in preferred stock dividends paid.

MARKET RISK MANAGEMENT

The Company's market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2004.

OTHER MATTERS

As of June 30, 2005, the Company believes that it is in full compliance with the REIT tax rules, and expects to qualify as a non-taxable REIT under the provisions of the Internal Revenue Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

FINANCIAL STATEMENTS OF HARRIS N.A.

The following unaudited financial information for the Bank is included because the Company's preferred shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.

On May 27, 2005, Harris Bankcorp, Inc., the Bank's parent company, consolidated twenty-six of its separate bank subsidiaries in Illinois (including Harris Trust and Savings Bank, the parent company of Harris Capital Holdings, Inc. at that date) into one national bank, Harris N.A. Each outstanding share of the Company's Series A Preferred Stock became automatically exchangeable for one newly issued preferred share of Harris N.A. under the same exchange conditions previously in existence for preferred shares of Harris Trust and Savings Bank, except that the primary regulator for purposes of the exchange conditions will be the Office of the Comptroller of the Currency, not the Board of Governors of the Federal Reserve Bank. References herein to the "Bank" for those times prior to the charter consolidation are intended to refer to Harris Trust and Savings Bank.

Financial statements are presented for the Bank using the historical cost basis for all combining entities, similar to pooling-of-interests accounting. Results for prior periods have been restated assuming the combination had taken place before the earliest period presented.

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CONDITION

	JUNE 30 2005	DECEMBER 31 2004	JUNE 2004
		(UNAUDITED) (IN THOUSANDS EXCEPT SHARE DATA)	
ASSETS			
Cash and demand balances due from banks	$ 910,664	$ 947,580	$ 1,177
Money market assets:			
Interest-bearing deposits at banks	667,715	662,366	410
Federal funds sold	180,666	94,950	466
Securities available-for-sale (including $3.07 billion, $4.27 billion, and $2.78 billion of securities pledged as collateral for repurchase agreements at June 30, 2005, December 31, 2004 and June 30, 2004, respectively)	7,459,925	7,154,743	6,896
Trading account assets	127,493	90,130	94
Loans	21,567,937	20,218,993	19,146
Allowance for loan losses	(308,942)	(316,575)	(329
Net loans	21,258,995	19,902,418	18,816
Premises and equipment	407,880	455,211	442
Bank-owned insurance	1,092,776	1,072,660	1,053
Loans held for sale	51,237	43,423	122
Goodwill and other intangible assets	298,615	306,760	315
Other assets	622,688	594,085	635
TOTAL ASSETS	$33,078,654	$31,324,326	$30,432
LIABILITIES			
Deposits in domestic offices -- noninterest-bearing	$ 5,251,930	$5,372,605	$ 5,254
-- interest-bearing	16,402,911	15,646,690	15,747
Deposits in foreign offices -- interest-bearing	1,207,928	1,677,428	1,016
Total deposits	22,862,769	22,696,723	22,018
Federal funds purchased and securities sold under agreement to repurchase	4,207,670	4,613,046	4,330
Short-term borrowings	1,622,430	120,795	447
Short-term senior notes	400,000	200,000	100
Accrued interest, taxes and other expenses	214,655	227,539	216
Other liabilities	281,500	289,131	218
Minority interest-preferred stock of subsidiary	250,000	250,000	250
Preferred stock issued to Harris Bankcorp, Inc.	--	5,000	5
Long-term notes -- senior	250,000	--	
Long-term notes -- subordinated	292,750	292,750	292
TOTAL LIABILITIES	30,381,774	28,694,984	27,879
STOCKHOLDER'S EQUITY			
Common stock ($10 par value); 40,000,000 shares authorized, 13,487,257 shares issued and outstanding	134,873	134,873	134
Surplus	1,062,631	1,061,314	1,056
Retained earnings	1,536,991	1,477,163	1,413
Accumulated other comprehensive loss	(37,615)	(44,008)	(51

TOTAL STOCKHOLDER'S EQUITY	2,696,880	2,629,342	2,553
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$33,078,654	$31,324,326	$30,432

The accompanying notes to consolidated financial statements are an integral part of these statements.

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30		SIX MONTHS END JUNE 30	
	2005	2004	2005	20
	(IN THOUSANDS)			
INTEREST INCOME				
Loans	$286,959	$231,425	$553,682	$453
Money market assets:				
Deposits at banks	2,362	882	4,567	1
Federal funds sold and securities purchased under agreement to resell	1,622	1,295	3,167	1
Trading accounts	1,449	622	2,577	
Securities available-for-sale:				
U.S. Treasury and federal agency	39,921	34,425	72,354	74
State and municipal	4,783	4,862	9,267	9
Other	4,587	2,664	8,609	3
Total interest income	341,683	276,175	654,223	546
INTEREST EXPENSE				
Deposits	101,781	57,864	189,069	115
Short-term borrowings	36,361	10,388	63,763	20
Senior notes	4,147	1,273	5,887	1
Minority interest-dividends on preferred stock of subsidiary	4,609	4,609	9,218	9
Long-term notes	2,390	2,326	4,581	5
Total interest expense	149,288	76,460	272,518	152
NET INTEREST INCOME	192,395	199,715	381,705	394
Provision for loan losses	1,292	3,760	3,441	27
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	191,103	195,955	378,264	367
NONINTEREST INCOME				
Trust and investment management fees	23,667	23,246	47,093	46
Money market and bond trading	2,542	3,574	5,132	5
Foreign exchange	1,425	1,435	2,640	3
Service charges and fees	32,842	33,480	62,327	65
Net securities gains (losses)	157	14,113	(80)	25
Bank-owned insurance	9,880	10,116	20,126	20

Gains from loan restructuring	--	--	--	7
Letter of credit fees	4,958	5,820	10,488	12
Other	29,121	29,983	59,098	62
Total noninterest income	104,592	121,767	206,824	248
NONINTEREST EXPENSES				
Salaries and other compensation	90,484	91,219	179,870	182
Pension, profit sharing and other employee benefits	27,116	27,091	53,567	53
Net occupancy	18,131	15,230	34,791	31
Equipment	13,199	14,325	26,681	28
Marketing	10,258	9,243	18,796	18
Communication and delivery	4,537	5,599	10,551	11
Expert services	5,770	6,424	11,973	12
Contract programming	6,613	5,268	14,081	13
Other	31,978	29,851	66,042	59
	208,086	204,250	416,352	411
Amortization of intangibles	4,068	4,124	8,146	8
Total noninterest expenses	212,154	208,374	424,498	419
Income before income taxes	83,541	109,348	160,590	196
Applicable income taxes	25,453	36,106	49,700	63
NET INCOME	$ 58,088	$ 73,242	$110,890	$132

The accompanying notes to consolidated financial statements are an integral part of these statements.

11

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30		SIX MONTHS ENDED JUNE 30	
	2005	2004	2005	2004
	(IN THOUSANDS)			
Net income	$58,088	$73,242	$110,890	$132,836
Other comprehensive income (loss):				
Cash flow hedges:				
Net unrealized gain (loss) on derivative instruments, net of tax expense (benefit) for the quarter of $4,793 in 2005 and ($461) in 2004 and net of tax (benefit) year-to-date period of ($540) in 2005 and ($541) in 2004	8,161	(784)	(919)	(921)
Minimum pension liability adjustment net of tax expense for the quarter of zero in 2005 and $2,368 in 2004 and net of tax expense for the year-to-date period of zero in 2005 and $2,290 in 2004	--	(2,368)	--	(2,490)

Unrealized gains (losses) on available-for-sale securities:				
Unrealized holding gains (losses) arising during the period, net of tax expense (benefit) for the quarter of $4,924 in 2005 and ($36,169) in 2004 and net of tax expense (benefit) for the year-to-date period of $3,889 in 2005 and ($34,472) in 2004	9,158	(55,566)	7,263	(53,498)
Less reclassification adjustment for realized (gains) losses included in income statement, net of tax expense for the quarter of $61 in 2005 and $5,489 in 2004 and net of tax (benefit) expense for the year-to-date period of ($31) in 2005 and $9,976 in 2004	(96)	(8,624)	49	(15,448)
Other comprehensive income (loss)	17,223	(67,342)	6,393	(72,357)
Comprehensive income	$75,311	$ 5,900	$117,283	$ 60,479

The accompanying notes to consolidated financial statements are an integral part of these statements.

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
(UNAUDITED)

	2005	2004
	(IN THOUSANDS)	
BALANCE AT JANUARY 1	$2,629,342	$2,521,778
Net income	110,890	132,836
Contributions to capital	1,317	7,512
Contribution of parent's banking assets	--	36,938
Dividend of non-bank subsidiary	--	(5,357)
Adjustment of prior quarters' preferred dividends	--	767
Dividends -- preferred stock	(62)	(53)
Dividends -- common stock	(51,000)	(69,000)
Other comprehensive income (loss)	6,393	(72,357)
BALANCE AT JUNE 30	$2,696,880	$2,553,064

The accompanying notes to consolidated financial statements are an integral part of these statements.

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30 2005	SIX MONTHS ENDED JUNE 30 2004
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 110,890	$ 132,836
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,441	27,035
Depreciation and amortization, including intangibles	35,601	38,983
Deferred tax (benefit) expense	(34,347)	(4,535)
Net loss (gain) on sales of securities	80	(25,424)
Increase in bank-owned insurance	(20,116)	(19,950)
Trading account net cash purchases	(17,954)	(43,980)
Net increase (decrease) in interest receivable	(8,118)	11,282
Net increase (decrease) in interest payable	15,811	(5,361)
Net (increase) decrease in loans held for sale	(7,814)	46,472
Other, net	10,269	31,366
Net cash provided by operating activities	87,743	188,724
INVESTING ACTIVITIES:		
Net increase (decrease) in interest-bearing deposits at banks	(5,349)	14,448
Net increase in Federal funds sold and securities purchased under agreement to resell	(85,716)	(381,971)
Proceeds from sales of securities available-for-sale	86,564	2,418,548
Proceeds from maturities of securities available-for-sale	2,465,697	3,332,459
Purchases of securities available-for-sale	(2,875,727)	(4,424,980)
Net increase in loans	(1,372,648)	(1,168,920)
Purchases of premises and equipment	(33,048)	(38,862)
Other, net	107,859	1,753
Net cash used by investing activities	(1,712,368)	(247,525)
FINANCING ACTIVITIES:		
Cash received in contribution of parent's banking assets	--	3,380
Net increase in deposits	97,349	332,441
Net decrease in Federal funds purchased and securities sold under agreement to repurchase	(405,376)	(319,869)
Net increase in other short-term borrowings	1,501,736	310,895
Proceeds from issuance of senior notes	1,400,000	1,130,000
Repayment of senior notes	(950,000)	(1,030,000)
Proceeds from issuance of long-term notes	--	206,250
Repayment of long-term notes	--	(225,000)
Cash dividends paid on common stock	(51,000)	(69,000)
Cash portion of dividend of non-bank subsidiary	--	(5,076)
Retirement of preferred stock	(5,000)	--
Net cash provided by financing activities	1,587,709	334,021
NET (DECREASE) INCREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS	(36,916)	275,220
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1	947,580	902,404

CASH AND DEMAND BALANCES DUE FROM BANKS AT JUNE 30.....	$ 910,664	$ 1,177,624
	===========	===========

The accompanying notes to consolidated financial statements are an integral part of these statements.

14

HARRIS N.A. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Harris N.A. (the "Bank") is a wholly-owned subsidiary of Harris Bankcorp, Inc. ("Bankcorp"), a wholly-owned subsidiary of Harris Financial Corp., a wholly-owned subsidiary of Bank of Montreal. The consolidated financial statements of the Bank include the accounts of the Bank and its wholly-owned subsidiaries. Significant intercompany accounts and transactions have been eliminated. Certain reclassifications were made to conform prior year's financial statements to the current year's presentation.

On May 27, 2005 Bankcorp consolidated 26 of its individually chartered bank subsidiaries (including Harris Trust and Savings Bank) into one national bank, Harris N.A. The combination was recorded at historical carrying value and prior year financial statements have been restated. Harris N.A. is subject to regulation by the Office of the Comptroller of the Currency.

The consolidated financial statements have been prepared by management from the books and records of the Bank, without audit by independent certified public accountants. However, these statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented.

Because the results of operations are so closely related to and responsive to changes in economic conditions, the results for any interim period are not necessarily indicative of the results that can be expected for the entire year.

2. LEGAL PROCEEDINGS

The Bank and certain of its subsidiaries are defendants in various legal proceedings arising in the normal course of business. In the opinion of management, based on the advice of legal counsel, the ultimate resolution of these matters will not have a material adverse effect on the Bank's consolidated financial position.

3. CASH FLOWS

For purposes of the Bank's Consolidated Statements of Cash Flows, cash and cash equivalents is defined to include cash and demand balances due from banks. Cash interest payments for the six months ended June 30 totaled $256.7 million and $157.4 million in 2005 and 2004, respectively. Cash income tax payments over the same periods totaled $40.2 million and $27.6 million, respectively.

4. GOODWILL AND OTHER INTANGIBLE ASSETS

The Bank records goodwill and other intangible assets in connection with the acquisition of assets from unrelated parties or the acquisition of new subsidiaries. Goodwill and other intangible assets that have indefinite useful lives are not subject to amortization while intangible assets with finite lives are amortized. Goodwill is periodically assessed for impairment, at least annually. Intangible assets with finite lives are amortized on either an accelerated or straight-line basis depending on the character of the acquired asset. Intangible assets are reviewed for impairment when events or future assessments of profitability indicate that the carrying value may not be recoverable.

The carrying value of the Bank's goodwill was $214 million at both June 30, 2005 and 2004, respectively. No impairment was recorded during the quarter ended June 30, 2005.

Besides goodwill, the Bank did not have any intangible assets not subject to amortization as of June 30, 2005 and 2004.

As of June 30, 2005, the gross carrying amount and accumulated amortization of the Bank's amortizable intangible assets are included in the following table.

	JUNE 30, 2005		JUNE 30, 2005	JUNE 30, 2004
	GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION	NET CARRYING VALUE	2004 NET CARRYING VALUE
	(IN THOUSANDS)			
Branch network	$145,000	$ (87,000)	$58,000	$ 67,667
Core deposits	53,161	(26,172)	26,989	33,662
Total finite life intangibles	$198,161	$(113,172)	$84,989	$101,329

Total amortization expense for the Bank's intangible assets was $4.1 million for each of the quarters ended June 30, 2005 and June 30, 2004.

Estimated intangible asset amortization expense (assuming the current level of intangible assets) for the years ending December 31, 2005, 2006, 2007, 2008 and 2009 is $16.3 million, $16.3 million, $16.2 million, $16.2 million and $13.3 million, respectively.

5. SALE OF BUILDING

On March 1, 2005, the Bank sold to a third party the land and building located at 111 W. Monroe Street in Chicago. Upon sale, the Bank entered into a leaseback agreement for approximately 50 percent of the building space with an average lease term of 16 years. The leaseback agreement meets the criteria to be recorded as an operating lease. The sale resulted in a gain of $55.8 million, all of which was deferred and will be amortized over the term of the leaseback.

HARRIS N.A. AND SUBSIDIARIES

FINANCIAL REVIEW

SECOND QUARTER 2005 COMPARED WITH SECOND QUARTER 2004

SUMMARY

The Bank had second quarter 2005 net income of $58.1 million, a decrease of $15.2 million or 21 percent from second quarter 2004.

Second quarter net interest income on a fully taxable equivalent basis was $197.8 million, down $6.8 million or 3 percent from $204.6 million in 2004's second quarter. Average earning assets increased 7 percent to $29.66 billion from $27.69 billion in 2004, due in part to an increase of $2.1 billion in average loans. Net interest margin decreased to 2.67 percent in the current quarter from 2.97 percent in the year-ago quarter, reflecting the impact of higher rates on deposits and the issuance of higher-cost incremental wholesale supporting funds. This was somewhat offset by higher yields in the loan portfolio and solid loan growth, particularly retail loans.

The second quarter 2005 provision for loan losses of $1.3 million was down from $3.8 million in the second quarter of 2004. Net charge-offs decreased to $2.2 million from $11.2 million in the prior year. The decrease in provision resulted from a reduction in net charge-offs and management's assessment that declining non-performing loan levels will result in potentially lower loan losses.

Second quarter noninterest income of $104.6 million decreased $17.1 million or 14 percent from the same quarter last year. This was largely attributable to a reduction in gains from sales of investment securities amounting to $14.0 million. Money market and bond trading income decreased by $1.0 million and letter of credit fees declined $0.9 million.

Second quarter 2005 noninterest expenses of $212.2 million increased $3.9 million from the year ago quarter. The increase reflects higher occupancy costs of $2.9 million related to the sale of a building in 2005 and higher expenses for outsourced administrative and technology activities of $2.3 million, partially offset by lower equipment expense of $1.1 million. Income tax expense decreased $10.7 million, reflecting lower pretax income from year ago results.

Nonperforming assets at June 30, 2005 were $146 million or 0.68 percent of total loans, down from $151 million or 0.72 percent at March 31, 2005, and $166 million or 0.75 percent a year ago. At June 30, 2005, the allowance for possible loan losses was $309 million, equal to 1.43 percent of loans outstanding, compared to $330 million or 1.72 percent of loans outstanding at the end of second quarter 2004. As a result, the ratio of the allowance for possible loan losses to nonperforming assets increased from 198 percent at June 30, 2004 to 211 percent at June 30, 2005.

At June 30, 2005, Tier 1 capital of the Bank amounted to $2.66 billion, up from $2.53 billion one year earlier. The regulatory leverage capital ratio was 8.15 percent for the second quarter of 2005 compared to 8.31 percent in the same quarter of 2004. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's June 30, 2005 Tier 1 and total risk-based capital ratios were 9.46 percent and 11.61 percent compared to respective ratios of 9.89 percent and 12.28 percent at June 30, 2004.

SIX MONTHS ENDED JUNE 30, 2005 COMPARED WITH JUNE 30, 2004

SUMMARY

The Bank had net income for the six months ended June 30, 2005 of $110.9 million, a decrease of $21.9 million or 17 percent from the same period a year ago.

Net interest income on a fully taxable equivalent basis was $391.7 million, down $12.6 million or 3 percent from $404.3 million in 2004's year-to-date period. Average earning assets increased 7 percent to $29.13 billion from $27.26 billion in 2004. Net interest margin decreased to 2.70 percent from 2.99 percent in 2004, reflecting the impact of higher rates on deposits and the issuance of higher-cost incremental wholesale supporting funds. This was somewhat offset by higher yields in the loan portfolio and strong retail loan growth.

The year-to-date 2005 provision for loan losses of $3.4 million was down $23.6 million from $27.0 million in 2004. Net charge-offs were $11.1 million, a decrease of $11.0 million from last year, resulting from lower commercial loan write-offs. The decrease in provision resulted from a reduction in net charge-offs and management's assessment that declining non-performing loan levels will result in potentially lower loan losses.

Noninterest income of $206.8 million decreased $41.8 million or 17 percent from the same period last year. This was largely due to a reduction in gains from sales of securities amounting to $25.5 million, a $7.1 million gain realized in 2004 by the Bank on the sale of assets received in an earlier troubled debt restructuring and a $7.7 million gain realized in 2004 by the Bank on the termination of a swap. Additionally, service fees and charges decreased by $3.4 million, mortgage origination fees decreased $2.7 million and mutual fund fees decreased $2.1 million. This was somewhat offset by higher ATM and debit card fees, commissions and syndication fees.

Noninterest expenses of $424.5 million increased $5.2 million or 1 percent from the year-ago period. The increase reflects higher expenses for outsourced administrative and technology activities of $8.9 million and higher occupancy costs of $3.5 million related to the sale of a building in 2005. This was partially offset by lower employment costs, including benefits, of $3.0 million and lower equipment expense of $1.6 million. Income tax expense decreased $13.9 million, reflecting lower pretax income from year-ago results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See "Liquidity Risk Management" and "Market Risk Management" under Management's Discussion and Analysis of Financial Condition and Results of Operations on page 6.

ITEM 4. CONTROLS AND PROCEDURES

As of June 30, 2005, Paul R. Skubic, the Chairman of the Board, Chief Executive Officer and President of the Company, and Janine Mulhall, the Chief Financial Officer of the Company, evaluated the effectiveness of the disclosure controls and procedures of the Company and concluded that these disclosure controls and procedures are effective to ensure that material information required to be included in this Report has been recorded, processed, summarized and made known to them in a timely fashion, as appropriate to allow timely discussion regarding disclosures. There was no change in the Company's internal control over financial reporting identified in connection with such evaluations that occurred during the quarter ended June 30, 2005 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEMS 1, 2, 3, 4 AND 5 ARE BEING OMITTED FROM THIS REPORT BECAUSE SUCH ITEMS ARE NOT APPLICABLE TO THE REPORTING PERIOD.

ITEM 6. EXHIBITS

31.1 CERTIFICATION OF JANINE MULHALL PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

31.2 CERTIFICATION OF PAUL R. SKUBIC PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

32.1 CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Harris Preferred Capital Corporation has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on the 12th day of August 2005.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chief Executive Officer

/s/ JANINE MULHALL

Janine Mulhall
Chief Financial Officer